



The Monetary Policy Committee of the Central Bank of Iceland

Minutes of the Monetary Policy Committee meeting, March 2016

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The Act on the Central Bank of Iceland stipulates that it is the role of the Monetary Policy Committee (MPC) to set Central Bank interest rates and apply other monetary policy instruments. Furthermore, the Act states that “[m]inutes of meetings of the Monetary Policy Committee shall be made public, and an account given of the Committee’s decisions and the premises upon which they are based.” In accordance with the Act, the MPC has decided to publish the minutes of its meetings two weeks after each interest rate decision. The votes of individual Committee members will be made public in the Bank’s *Annual Report*.

The following are the minutes of the MPC meeting held on 15 March 2016, during which the Committee discussed economic and financial market developments, the interest rate decision of 16 March, and the communication of that decision.

I Economic and monetary developments

Before turning to the interest rate decision, members discussed the domestic financial markets, financial stability, the outlook for the global economy and Iceland’s international trade, the domestic economy, and inflation, with emphasis on information that has emerged since the 10 February interest rate decision.

Financial markets

The exchange rate of the króna had risen by 0.4% in trade-weighted terms, by 0.2% against the US dollar, by 1.3% against the euro, and by 2.5% against the pound sterling since the February meeting. The Central Bank’s net accumulated foreign currency purchases in the domestic foreign exchange market totalled 180 million euros (25.5 b.kr.) between meetings, or about 52% of total market turnover.

As before, overnight interest rates in the interbank market for krónur were below the centre of the interest rate corridor, close to the Bank’s key rate. Turnover in the interbank market totalled 25.5 b.kr. in February, similar to that in the preceding three months.

In terms of the Central Bank’s real interest rate, the monetary stance was broadly unchanged since the Committee’s February meeting. At the time of the March meeting, the Bank’s real rate was 2.7% in terms of the average of various measures of inflation and inflation expectations and 3.5% in terms of past twelve-month inflation.

When the Committee met in March, yields on nominal Treasury bonds were similar to those seen at the time of the February meeting, or 6.0-6.2%. Yields on indexed Government and Housing Financing Fund (HFF) bonds were also about the same as at the time of the February meeting, or 2.7-2.8%.

The large commercial banks' indexed and non-indexed deposit and lending rates were unchanged since the February meeting, as was the pension funds' average mortgage lending rate.

The risk premium on the Republic of Iceland's foreign obligations had declined between meetings, and the rise at the beginning of the year had reversed. The CDS spread on five-year Treasury obligations was about 0.3 percentage points less than at the time of the February meeting. It measured just under 1%, the lowest since the beginning of 2008. The risk premium as measured by the interest rate spread between Icelandic Treasury bonds and comparable bonds issued by the US and Germany had narrowed by roughly 0.3 percentage points since February, however, to about 1½ percentage points.

Financial institutions' analysts had all expected the Central Bank's nominal interest rates to be held unchanged in March, mainly citing, as before, low inflation that was still below the Bank's inflation target.

M3 grew by 3.2% year-on-year in January. The annual growth rate is lower than it has been in recent months, owing mainly to a contraction in deposits held by financial institutions in winding-up proceedings. After adjusting for these deposits, year-on-year growth in M3 was much stronger, or 11%. The total stock of loans from deposit institutions, the Housing Financing Fund (HFF), and pension funds to resident borrowers contracted by about 1½% year-on-year in January. The credit stock adjusted for the Government's debt relief measures was estimated to have grown by 0.2% year-on-year.

The NASDAQ OMXI8 index had risen by 6.4% between meetings in March. The index had risen by 1.7% since year-end 2015, and the decline at the beginning of this year had therefore reversed. Turnover in the main market totalled just over 112 b.kr. in the first two months of the year, considerably more than during the same period in 2015.

Global economy and external trade

The deficit on Iceland's goods trade totalled about 2.8 b.kr. in the first two months of the year, about the same as during the same period in 2015. Export values contracted by 6.8% year-on-year at constant exchange rates, while import values fell by 6.4%. The export value of industrial goods declined by 21% year-on-year while the export value of marine products rose by nearly 9%. The contraction in imports is due mainly to a 37% year-on-year contraction in transport equipment imports, a 32% contraction in imports of fuel and lubricants, and a more than 12% contraction in imports of commodities and operational inputs.

In terms of relative consumer prices, the real exchange rate rose by 10% year-on-year in February. The increase is due primarily to a 8.2% nominal appreciation of the króna, but in addition, inflation in Iceland was about 1.7 percentage points above the average among its trading partners.

The listed global market price of aluminium was virtually unchanged since the February meeting, and the average February price was down almost 16% year-on-year. Foreign

currency prices of marine products had declined by 1% month-on-month in January but had risen by over 3% year-on-year.

The domestic real economy and inflation

According to preliminary figures published by Statistics Iceland in March, year-on-year GDP growth measured 3.2% in Q4/2015. Domestic demand grew 7.5% year-on-year during the quarter. Of that total, consumption and total investment grew by 9%. Imports grew strongly, and the contribution from net trade was therefore negative in spite of 10.6% export growth.

GDP growth measured 4% in 2015, reflecting the offsetting effects of 6.3% growth in domestic demand and the negative contribution from net trade. GDP growth for the year was in line with the Bank's February forecast of 4.1%. The composition of GDP growth for the year was also well in line with the forecast. The forecast had assumed stronger growth in domestic demand than Statistics Iceland figures indicated, however. Consumption and investment developed in line with the forecast, and the deviation in domestic demand was therefore due to inventory changes. The contribution from net trade was more positive than was provided for in the forecast, however, primarily due to stronger exports.

The underlying current account balance was positive by 108 b.kr. in 2015, or 4.9% of GDP, broadly the same as in 2014. The surplus on goods and services trade was larger than in the previous year, while secondary income was more strongly negative, largely due to the 20 b.kr. settlement payment made by the Depositors' and Investors' Guarantee Fund (DIGF) to the British deposit guarantee scheme and the Dutch central bank. The forecast in the February *Monetary Bulletin* assumed that the current account surplus had amounted to 3.7% of GDP in 2015. The deviation is due largely to stronger-than-expected returns on foreign direct investment, although the surplus on services trade was also larger than anticipated. Iceland's international investment position also improved markedly in 2015 following the conclusion of composition agreements by the failed banks' estates, measuring -14.5% of GDP at the end of the year.

In Q4/2015, private consumption growth was somewhat stronger than in the first three quarters of the year. Key indicators from Q1/2016 suggest that growth will pick up even more. Payment card turnover in January and February was up by just over 13% year-on-year. There was also a marked increase in the number of new motor vehicle registrations in the first two months of 2016, and most retail sales indices indicate that sales were up at the start of the year.

The Gallup Consumer Sentiment Index measured 118.5 points in February, slightly lower than in January but 27 points higher than in February 2015. All subindices declined between January and February; however, they were much higher than in 2015, owing mainly to an improvement in the assessment of the current situation.

According to the results of Gallup's spring survey, carried out in February among executives from Iceland's 400 largest firms, optimism about the economic outlook six months ahead increased somewhat in comparison with the winter survey, conducted in November. About 76% of respondents considered the current situation good, and a fifth considered it neither poor nor good. Just under 44% of executives were of the view that economic conditions would improve in the next six months, and about 47% expected conditions to remain unchanged (i.e., good). Construction industry executives were more optimistic than others about the six-month outlook, and their assessment improved most from the winter survey. In

addition, executives in transport and tourism were somewhat more optimistic than in November. Overall, executives were more optimistic than they were a year ago, except for those in the financial services and fishing sectors. About 9% of executives were of the opinion that conditions would deteriorate over the next six months.

Executives seem more optimistic about domestic demand than at any time since measurements began in 2004, with about 60% indicating that they expected demand for their goods and services to increase in the next six months. Expectations concerning foreign demand in the next six months were strong as well but have subsided somewhat since year-end 2014.

According to Gallup's spring survey, firms interested in recruiting staff in the next six months outnumbered those planning redundancies by nearly a third. This indicates considerably more optimism than in both the winter survey and the survey conducted a year ago. The percentage is at its highest since 2007, as is the number of firms planning to hire employees in coming months. The change since the last survey is due both to an increase in the number of firms planning to recruit and to a decline in the number planning to lay workers off. Executives in all industries except fishing were more optimistic about staff recruitment than in the last survey, and those selling their products overseas were more so than those selling their products domestically.

Just under a third of firms considered themselves short-staffed, the largest share since year-end 2007 and an increase of more than 13 percentage points year-on-year. Almost 60% of construction firms and nearly 40% of firms in transport and tourism considered themselves short-staffed. Construction companies planning to add on staff in the next six months outnumbered those planning redundancies by about 70 percentage points, and in the transport and tourism sector, almost half of firms were planning to recruit and none were planning to downsize.

Just over half of respondents in the spring survey considered themselves able to respond to an unexpected surge in demand, a decline of 10 percentage points year-on-year and more than 25 percentage points from the 2011 peak.

According to the Statistics Iceland labour force survey (LFS), labour demand growth continued in January. Seasonally adjusted unemployment measured 2.5% in January, having declined by 1½ percentage points between years. Seasonally adjusted unemployment has therefore been below 3% for two months in a row, the lowest level seen since mid-2008.

The wage index rose by 0.4% month-on-month in January and by 9.4% year-on-year. Real wages in terms of the index had risen by 6.5% year-on-year in January.

Statistics Iceland's nationwide house price index, published at the end of February, rose by 1.1% month-on-month, after adjusting for seasonality, and by 8.5% year-on-year. The capital area house price index, calculated by Registers Iceland, rose by 0.9% month-on-month in January when adjusted for seasonality, and by 8.5% year-on-year. The number of registered purchase agreements nationwide rose 26.7% between years in January. The average time-to-sale for flats in the greater Reykjavík area was about 3.5 months in January, down from 4.1 months in January 2015.

The consumer price index (CPI) rose by 0.7% month-on-month in February, raising twelve-month inflation to 2.2%, slightly more than in January. The CPI excluding the housing component had risen by only 0.7% in the past twelve months, however. Underlying inflation according to core index 3 excluding tax effects had risen since the February meeting and

measured 2.6%, its highest since summer 2014. Statistical measures of underlying inflation suggest that it lay in the 2-3½% range.

The main drivers of the increase in the CPI in February were end-of-sale effects and rising house prices. The reductions in furniture, housewares, and electronic equipment prices in January reversed in full, and the effects were stronger than they were a year earlier. International airfares declined somewhat in February and were 5.4% lower than they were at the same time in 2015. Other services items rose somewhat in price, however. Private services prices had risen by 2.2% in the past twelve months, as opposed to 2.6% in January.

According to Gallup's spring survey of household inflation expectations, carried out in February, households expected inflation to measure 3.4% one year ahead, or 0.6 percentage points less than in the winter survey, carried out in November. Households' one-year expectations are still nearly ½ a percentage point higher than they were a year ago, however. On the other hand, two-year inflation expectations were unchanged at 4%. According to Gallup's spring survey among executives, respondents' one-year inflation expectations had declined by 0.6 percentage points between surveys, to 3%, whereas two-year inflation expectations were unchanged at 3.5%.

The breakeven inflation rate in the bond market was broadly unchanged between meetings. The breakeven rate two year ahead was 3.3% just before the March meeting, or about 0.2 percentage points higher than at the February meeting, while the breakeven rate five and ten years ahead was unchanged at just over 3%. In February, the ten-year breakeven rate averaged just under 1 percentage point lower than at the same time in 2015.

II The interest rate decision

The Governor informed the MPC that the analysis in connection with special capital flow management tools designed to affect carry trade-related capital inflows was well advanced. He also updated the Committee on matters relating to the Bank's capital account liberalisation strategy, including the planned auction of offshore krónur.

Because the timing of the auction had not been decided, members did not consider it timely to change reserve requirements, although the Committee had decided in December that, other things being equal, reserve requirements should be lowered back to 2% in connection with the auction.

Committee members discussed whether developments since the last meeting had changed its assessment of whether the monetary stance was appropriate and whether the outlook had changed. At the February meeting, the MPC had decided to hold interest rates unchanged, in view of an improved near-term outlook, although the Committee considered it likely that the monetary stance would have to be tightened in the coming term.

Only a short time had passed since the previous meeting, and the information published in the interim largely supported the Committee's previous assessment of the economy. In the MPC's opinion, growth in economic activity was broadly in line with the Committee's assessment at the February meeting. According to preliminary figures from Statistics Iceland, GDP growth measured 4% in 2015, well in line with the Central Bank's February forecast. Committee members agreed that the indicators that had emerged year-to-date suggested that the outlook for 2016 was broadly unchanged, with the prospect of robust GDP growth in the coming term. Indicators of private consumption and from the labour market also implied that demand had grown rapidly in the recent past.

Members also noted that the inflation outlook was broadly as assumed in the Bank's February forecast. Inflation measured 2.2% in February and had risen by just over 1 percentage point in the past year. As before, Committee members were of the view that domestic inflationary pressures and imported global deflation tended to offset one another. In their opinion, inflation looked set to remain below target well into the year, but the outlook was still uncertain, including for import prices.

In view of this, no members saw any reason to change interest rates at present. Committee members agreed that it was appropriate to pause and hold rates unchanged, as the Bank's new forecast, including an assessment of the effects of recent developments on the medium-term inflation outlook, would be available at the time of the next meeting. In view of the discussion, the Governor proposed that the Bank's interest rates be held unchanged. The Bank's key rate (the seven-day term deposit rate) would remain 5.75%, the current account rate 5.5%, the seven-day collateralised lending rate 6.5%, and the overnight lending rate 7.5%. All Committee members voted in favour of the proposal.

Committee members agreed that even though global price developments and a stronger króna had provided the scope to raise interest rates more slowly than had previously been considered necessary, this did not change the fact that, according to the Bank's February forecast, a tighter monetary stance would probably be needed in the coming term, in view of growing domestic inflationary pressures. How much and how quickly the monetary stance must be tightened would depend on future developments.

The following Committee members were in attendance:

Már Gudmundsson, Governor and Chairman of the Monetary Policy Committee

Arnór Sighvatsson, Deputy Governor

Thórarinn G. Pétursson, Chief Economist

Gylfi Zoëga, Professor, external member

Katrín Ólafsdóttir, Assistant Professor, external member

In addition, a number of Bank staff members attended part of the meeting.

Rannveig Sigurdardóttir wrote the minutes.

The next Statement of the Monetary Policy Committee will be published on Wednesday 11 May 2016.